DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 02-20110627
Adjusted Gross Income Tax
For Tax Years 2007-09

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ISSUE

I. Adjusted Gross Income Tax–Research and Development Credits.

Authority: U.S. v. McFerrin, 570 F.3d 672 (5th Cir. 2009); Union Carbide Corp. and Subsidiaries v. Comm'r., T.C. Memo 2009-50, 2009 WL 605161(2009); I.R.C. § 41; Treas. Reg. § 1.41-2; IC § 6-3-2-1; IC § 6-3-1-3.5; IC § 6-3.1-4-1; IC § 6-3.1-4-4; IC § 6-8.1-5-1.

Taxpayer protests the reduction of claimed research and development credits.

STATEMENT OF FACTS

Taxpayer is an Indiana corporation. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had claimed research and development ("R & D") credits without documentation supporting the claimed amounts of credits on its Indiana adjusted gross income tax ("AGIT") returns for the 2007, 2008, and 2009 tax years. The Department therefore removed those credits from its calculations of Taxpayer's AGIT for those years, which resulted in additional AGIT due for 2007 and 2008, and a reduced refund for 2009. The Department therefore issued proposed assessments for AGIT and interest for 2007 and 2008. Taxpayer protests the removal of the claimed amounts of R & D credits and the resulting assessments and reduced refund. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Adjusted Gross Income Tax–Research and Development Credits.

DISCUSSION

Taxpayer protests the reduction of research and development credits which it claimed on its 2007, 2008, and 2009 Indiana AGIT returns, along with the resulting proposed assessments for additional AGIT due for 2007 and 2008 and a reduced refund for 2009. Taxpayer states that the R & D credits were properly claimed and supported. For its calculations, Taxpayer used a base period of an entity ("Entity") which it acquired. The base period years were 1984-88. Taxpayer did not have documentation such as general ledgers or financial statements upon which to base its calculations of the credit it claimed. In the course of determining the amount of its claimed credit, Taxpayer used wage information gathered from one of its employees ("Employee") who had worked for Entity during the base period years which Taxpayer used in its credit calculations. Taxpayer also used information from that same employee to complete the base period sales totals which Taxpayer used in its credit calculations. The Department denied Taxpayer's R & D credits in their entirety based on the determination that Taxpayer was unable to substantiate any of the numbers Taxpayer used to calculate the credits. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

For income tax purposes, Indiana follows the federal tax scheme with certain modifications. IC § 6-3-2-1(b); IC § 6-3-1-3.5(b). Indiana also provides certain tax credits which a taxpayer may claim to reduce its taxable income. One of the tax credits is the "Indiana qualified research expense tax credit" under IC § 6-3.1-4-1, which in relevant part states:

As used in this chapter:

"Base amount" means base amount (as defined in Section 41(c) of the Internal Revenue Code as in effect on January 1, 2001), modified by considering only Indiana qualified research expenses and gross receipts attributable to Indiana in the calculation of the taxpayer's:

(1) fixed base percentage; and

(2) average annual gross receipts.

"Indiana qualified research expense" means qualified research expense that is incurred for research conducted in Indiana.

"Qualified research expense" means qualified research expense (as defined in Section 41(b) of the Internal Revenue Code as in effect on January 1, 2001).

"Pass through entity" means:

(1) a corporation that is exempt from the adjusted gross income tax under IC 6-3-2-2.8(2);

(2) a partnership;

(3) a limited liability company; or

(4) a limited liability partnership.

"Research expense tax credit" means a credit provided under this chapter against any tax otherwise due and

payable under IC 6-3.

"Taxpayer" means an individual, a corporation, a limited liability company, a limited liability partnership, a trust, or a partnership that has any tax liability under IC 6-3 (adjusted gross income tax).

(Emphasis added).

IC § 6-3.1-4-4 provides:

The provisions of Section 41 of the Internal Revenue Code as in effect on January 1, 2001, and the regulations promulgated in respect to those provisions and in effect on January 1, 2001, are applicable to the interpretation and administration by the department of the credit provided by this chapter, including the allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period.

"Qualified research" is defined in I.R.C. § 41(d), as follows:

(1) In general.--The term "qualified research" means research--

(A) with respect to which expenditures may be treated as expenses under section 174,

(B) which is undertaken for the purpose of discovering information--

(i) which is technological in nature, and

(ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and

(C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3). Such term does not include any activity described in paragraph (4).

(2) Tests to be applied separately to each business component.--For purposes of this subsection--

(A) In general.--Paragraph (1) shall be applied separately with respect to each business component of the taxpayer.

(B) Business component defined.--The term "business component" means any product, process, computer software, technique, formula, or invention which is to be--

(i) held for sale, lease, or license, or

(ii) used by the taxpayer in a trade or business of the taxpayer.

(C) Special rule for production processes.--Any plant process, machinery, or technique for commercial production of a business component shall be treated as a separate business component (and not as part of the business component being produced).

(3) Purposes for which research may qualify for credit.--For purposes of paragraph (1)(C)--

(A) In general.--Research shall be treated as conducted for a purpose described in this paragraph if it relates to--

(i) a new or improved function,

(ii) performance, or

(iii) reliability or quality.

(B) Certain purposes not qualified.--Research shall in no event be treated as conducted for a purpose described in this paragraph if it relates to style, taste, cosmetic, or seasonal design factors.

(4) Activities for which credit not allowed.--The term "qualified research" shall not include any of the following:

(A) Research after commercial production.--Any research conducted after the beginning of commercial production of the business component.

(B) Adaptation of existing business components.--Any research related to the adaptation of an existing business component to a particular customer's requirement or need.

(C) Duplication of existing business component.--Any research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component.

(D) Surveys, studies, etc.--Any--

(i) efficiency survey,

(ii) activity relating to management function or technique,

(iii) market research, testing, or development (including advertising or promotions),

(iv) routine data collection, or

(v) routine or ordinary testing or inspection for quality control.

(E) Computer software.--Except to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in--

(i) an activity which constitutes qualified research (determined with regard to this subparagraph), or

(ii) a production process with respect to which the requirements of paragraph (1) are met.

(F) Foreign research.--Any research conducted outside the United States, the Commonwealth of Puerto Rico, or any possession of the United States.

(G) Social sciences, etc.--Any research in the social sciences, arts, or humanities.

(H) Funded research.--Any research to the extent funded by any grant, contract, or otherwise by another

person (or governmental entity).

I.R.C. § 41(b) also provides that:

Qualified research expenses.**--**For purposes of this section--

(1) Qualified research expenses.--The term "qualified research expenses" means the sum of the following amounts which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer--

(A) in-house research expenses, and

(B) contract research expenses.

(2) In-house research expenses.**--**

(A) In general.--The term "in-house research expenses" means--

(i) any wages paid or incurred to an employee for qualified services performed by such employee,

(ii) any amount paid or incurred for supplies used in the conduct of qualified research, and

(iii) under regulations prescribed by the Secretary, any amount paid or incurred to another person for the right to use computers in the conduct of qualified research.

Clause (iii) shall not apply to any amount to the extent that the taxpayer (or any person with whom the taxpayer must aggregate expenditures under subsection (f)(1)) receives or accrues any amount from any other person for the right to use substantially identical personal property.

(B) Qualified services.**--**The term " qualified services" means services consisting of--

(i) engaging in qualified research, or

(ii) engaging in the direct supervision or direct support of research activities which constitute qualified research.

If substantially all of the services performed by an individual for the taxpayer during the taxable year consists of services meeting the requirements of clause (i) or (ii), the term "qualified services" means all of the services performed by such individual for the taxpayer during the taxable year.

(C) Supplies.--The term "supplies" means any tangible property other than-

(i) land or improvements to land, and

(ii) property of a character subject to the allowance for depreciation.

(D) Wages.--

(i) In general.--The term "wages" has the meaning given such term by section 3401(a).

(ii) Self-employed individuals and owner-employees.--In the case of an employee (within the meaning of section 401(c)(1)), the term "wages" includes the earned income (as defined in section 401(c)(2)) of such employee.

(iii) Exclusion for wages to which work opportunity credit applies.-The term "wages" shall not include any amount taken into account in determining the work opportunity credit under section 51(a).

(Emphasis added).

Treas. Reg. § 1.41-2 further illustrates "qualified research expenses," in relevant part, that:

(a) Trade or business requirement--(1) In general. An in-house research expense of the taxpayer or a contract research expense of the taxpayer is a qualified research expense only if the expense is paid or incurred by the taxpayer in carrying on a trade or business of the taxpayer. The phrase "in carrying on a trade or business" has the same meaning for purposes of section 41(b)(1) as it has for purposes of section 162; thus, expenses paid or incurred in connection with a trade or business within the meaning of section 174(a) (relating to the deduction for research and experimental expenses) are not necessarily paid or incurred in carrying on a trade or business for purposes of section 41. A research expense must relate to a particular trade or business being carried on by the taxpayer at the time the expense is paid or incurred in order to be a qualified research expense. For purposes of section 41, a contract research expense of the taxpayer is not a qualified research expense if the product or result of the research is intended to be transferred to another in return for license or royalty payments and the taxpayer does not use the product of the research in the taxpayer's trade or business.

...

(c) Qualified services–

(1) Engaging in qualified research. The term "engaging in qualified research" as used in section 41(b)(2)(B) means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments).

(2) Direct supervision. The term "direct supervision" as used in section 41(b)(2)(B) means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). "Direct supervision" does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist.

(3) Direct support. The term "direct support" as used in section 41(b)(2)(B) means services in the direct support of either--

(i) Persons engaging in actual conduct of qualified research, or

(ii) Persons who are directly supervising persons engaging in the actual conduct of qualified research. For example, direct support of research includes the services of a secretary for typing reports describing laboratory results derived from qualified research, of a laboratory worker for cleaning equipment used in qualified research, of a clerk for compiling research data, and of a machinist for machining a part of an experimental model used in qualified research. Direct support of research activities does not include general administrative services, or other services only indirectly of benefit to research activities. For example, services of payroll personnel in preparing salary checks of laboratory scientists, of an accountant for accounting for research expenses, of a janitor for general cleaning of a research laboratory, or of officers engaged in supervising financial or personnel matters do not qualify as direct support of research. This is true whether general administrative personnel are part of the research department or in a separate department. Direct support does not include supervision. Supervisory services constitute "qualified services" only to the extent provided in paragraph (c)(2) of this section.

...

(d) Wages paid for qualified services--(1) In general. Wages paid to or incurred for an employee constitute in-house research expenses only to the extent the wages were paid or incurred for qualified services performed by the employee. If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense. In the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate, the amount of in-house research expense shall be determined by multiplying the total amount of wages paid to or incurred for the employee during the taxable year by the ratio of the total time actually spent by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year.

(2) "Substantially all." Notwithstanding paragraph (d)(1) of this section, if substantially all of the services performed by an employee for the taxpayer during the taxable year consist of services meeting the requirements of section 41(b)(2)(B) (i) or (ii), then the term "qualified services" means all of the services performed by the employee for the taxpayer during the taxable year. Services meeting the requirements of section 41(b)(2)(B) (i) or (ii) constitute substantially all of the services performed by the employee during a taxable year only if the wages allocated (on the basis used for purposes of paragraph (d)(1) of this section) to services meeting the requirements of section 41(b)(2)(B) (i) or (ii) constitute at least 80 percent of the wages paid to or incurred by the taxpayer for the employee during the taxable year.

(Emphasis added).

The Department denied the credits which Taxpayer claimed, basing its determination on the grounds that Taxpayer did not have any documentation to substantiate the numbers which Taxpayer used in its credit calculations. Taxpayer based the amount of wages which it claimed as qualified research expenses ("QREs") on information supplied by Employee. Employee was the department head of the relevant department during the base period years (1984-88) and provided the names of the four Entity employees (including Employee himself) who were engaged in qualifying activities during those years. Employee then estimated the wages of the four employees during those years based on his knowledge of his wages and wages paid in the industry during those years. Taxpayer then used these numbers as the wages it used in its credit calculations for the credits it claimed on its returns for the 2007, 2008, and 2009 tax years. The Department considered Employee's estimations of wages paid twenty years earlier to be inadequate to support Taxpayer's calculations on its claim for the R & D credit.

Taxpayer protests that the Department incorrectly disallowed the R & D credits for the years at issue. Taxpayer argues that testimony from an individual with extensive institutional knowledge such as Employee is an acceptable basis for calculating the R & D credit. Taxpayer refers to several court cases which it believes support this position. Taxpayer first refers to U.S. v. McFerrin, 570 F.3d 672 (5th Cir. 2009), which states in relevant part:

The government next argues that even if qualified research occurred, McFerrin failed to provide adequate documentation to substantiate the costs associated with that research. But this goes against the longstanding rule of Cohan v. Commissioner that if a qualified expense occurred, the court should estimate the allowable tax credit. 39 F.2d at 544. If McFerrin can show activities that were "qualified research," then the court should estimate the expenses associated with those activities. The district court need not credit McFerrin's reconstruction of expenses from years after the fact. See Eustace v. Comm'r, 81 T.C.M. (CCH) 1370, *5 (2001). But the court should look to testimony and other evidence, including the institutional knowledge of employees, in determining a fair estimate.

Taxpayer also refers generally to the United States Tax Court case Union Carbide Corp. and Subsidiaries v. Comm'r., T.C. Memo 2009-50, 2009 WL 605161 (2009). A relevant portion of the opinion provides:

One of petitioner's expert witnesses, Wendi Hinojosa, was responsible for costing the claim projects. Ms. Hinojosa was qualified as an expert in the accounting systems and documentation used by UCC in the credit years and the base period. Petitioner claims as QREs incurred by UCC in connection with the claim projects $23,356,600 for 1994 and $32,114,800 for 1995.

A. Cost Documentation Used

1. PCDs and MASs

The primary cost accounting records that Ms. Hinojosa used to calculate the cost of the supplies used in the claim projects were PCDs and material accounting summary reports (MASs). PCDs and MASs were part of UCC's material accounting system used to track variable costs (costs that vary with production) such as raw materials, catalysts, and other materials used in the manufacturing process. UCC used the material accounting system during both the credit years and the base period. There were no significant differences in UCC's material accounting system and related documentation during these two time frames.

The PCD was UCC's official cost accounting record for products that it manufactured. PCDs contained detailed cost information for every product that UCC manufactured, including the materials and quantities used in production. PCDs were produced monthly and annually, not for particular projects. The PCD for any given year consisted of approximately 3,000 pages.

MASs are inventory control reports containing a transaction summary for every material UCC manufactured or purchased, each of which was assigned a unique product code. Material production and consumption information was contained in both PCDs and MASs. However, PCDs were organized by manufactured product, whereas MASs were organized in numerical order by product code and listed all transactions for each product code by location.

Id at *42-3.

The Union Carbide court also provided:

The research credits claimed on petitioner's original returns and allowed by respondent included the wages of UCC's R & D scientists and engineers at its technical centers. Petitioner now seeks to treat as additional QREs amounts paid to operators at Taft and Star for the Amoco anticking and UCAT–J projects, respectively. For the Amoco anticoking project, petitioner treated as wage QREs the wages paid to Mr. Hyde, Mr. Tregre, and Mr. Gorenflo according to the number of hours each spent working on the project. Mr. Hyde and Mr. Tregre both credibly testified that they spent a combined total of 50 hours working on the Amoco anticoking project. We find that the services that Mr. Hyde and Mr. Tregre provided in connection with the Amoco anticoking project, including planning the tests, participating in the pretreatments, and sending the data to the technical center to be analyzed, constitute qualified services. While respondent argues that petitioner has not substantiated its claimed QREs, we find that the testimonies of Mr. Hyde, Mr. Tregre, and Ms. Hinojosa were credible and sufficiently substantiated the wages paid to these employees. We find that petitioner has satisfied its burden and may treat as wage QREs $835 and $210 for 1994 and 1995, respectively. However, Mr. Gorenflo did not testify as to how much time, if any, he spent on the Amoco anticoking project. Accordingly, petitioner has not satisfied its burden of proving that Mr. Gorenflo spent 2 hours engaged in qualified research with respect to the Amoco anticoking project in 1994 and may not claim his wages as QREs.

Id at *115.

(Emphasis added).

Taxpayer states that these cases support its position that the Department must allow Employee's estimates as adequate support for Taxpayer's R & D credit calculations. Also, Taxpayer provided a copy of Employee's annual Social Security report, which lists Employee's wages for the base years. Taxpayer believes that this confirms Employee's estimations and Taxpayer's R & D credit calculations. The Department disagrees.

First, the Department notes that the McFerrin decision was issued by the Fifth Circuit Court of Appeals, while Indiana is located in the Seventh Circuit. The McFerrin opinion is therefore not binding on Indiana. Next, the McFerrin opinion states that, if the taxpayer in that case could show activities that were "qualified research," then the court should estimate the expenses associated with those activities. The Department notes that Employee stated that qualifying activities took place, but did not show by any form of documentation that qualifying activities took place. Next, the opinion explained that the court should look to testimony and other evidence including the institutional knowledge of employees in determining a fair estimate of R & D credits.

The Department notes that, other than Employee's Social Security report, there is only Employee's institutional knowledge available in the instant case. There is no "testimony," since no one was under oath or penalties of perjury. There is no documentation available. The Department is not convinced that it is required to accept as fact the unsupported estimations of a single person regarding wages paid twenty years earlier to three other employees. As the Union Carbide court explained, the employees themselves testified as to the actual hours they worked on projects which qualified for the R & D credit. Similarly, Employee's Social Security report offers no explanation regarding Employee's activities on qualifying and non-qualifying projects. In the instant case, Employee simply lists his wages and estimates the wages of three other people, but offered no breakdown of how many hours were spent on qualifying projects and how many hours were spent on non-qualifying projects.

Taxpayer also protests the Department's determination that Taxpayer's calculations for base period sales were insufficiently documented. When Taxpayer acquired Entity, Entity supplied a sales report which formed the basis of Taxpayer's base period sales numbers used in the R & D credit calculations. The sales report did not cover all of the years in the base period; therefore Taxpayer used sales estimations from Employee for the 1984 and 1985 base years. The Department notes that the Union Carbide case, the court explained the accounting

background and expertise of the person who was responsible for determining Union Carbide's costing of the claim projects.

In the instant case, Taxpayer has used a basic sales report without any supporting documentation and which only covers a portion of the base years used in the R & D credit calculations. Taxpayer supplemented this report with estimations from Employee. Taxpayer has not established Employee's qualifications to make any determinations on sales numbers. The Department is not convinced that it is required to take as fact an unsupported sales report supplemented by the estimates of an employee who had no particular expertise regarding sales figures from twenty years before the estimates were made.

Taxpayer also protests the Department's determination that Taxpayer did not qualify for alternate base period calculations available to start-up companies. The Department's audit report explained that such a method is available to companies with fewer years of operation available to use as base years in R & D calculations, but did not agree to the use of that method. Taxpayer provided alternate calculations using the start-up method, but the Department did not accept the alternate calculations on the basis that Taxpayer would not amend its Federal returns to reflect that it was opting to be treated as a start-up company.

Taxpayer objects that if it had known that the Department would not accept the alternate figures that it would not have gone to the effort and expense of creating them. The Department acknowledges Taxpayer's frustration, but also points out that it has offered the option for Taxpayer to file amended Federal returns. The Department cannot agree to treat a taxpayer under start-up company rules in Indiana while that same taxpayer is treated under standard rules at the federal level.

In conclusion, Taxpayer has not established that Employee's estimations are a valid basis for arriving at the wage figures used in its R & D credit calculations. Neither has Taxpayer established that the base years' sales figures are accurate. Taxpayer's reliance on McFerrin is misplaced for several reasons, such as: 1) the case is from the Fifth Circuit, while Indiana is in the Seventh Circuit; 2) the institutional knowledge in that case came in the form of testimony, not a common statement of Employee's estimations; and, 3) the court's instructions were to use the testimony along with other evidence in arriving at a fair estimate. There is no other evidence in the instant case. Taxpayer's reliance on Union Carbide is misplaced for several reasons, such as: 1) Union Carbide offered testimony regarding wages while Taxpayer offers common statements of Employee's estimations; 2) Union Carbide established its witnesses' expertise and qualifications for making estimations, along with the available supporting documentation which those witnesses used in arriving at their estimations; and, 3) some of Union Carbide's employees offered breakdowns of the hours they spent on qualifying projects and hours spent on non-qualifying projects. The court rejected Union Carbide's claim for credit regarding its employee that did not offer a breakdown of hours spent on qualifying and non-qualifying projects. Taxpayer has offered only Taxpayer's estimations of salaries without reference to qualifying and non-qualifying projects. Taxpayer has not established Employee's qualifications to make estimations regarding sales for the base years. Taxpayer has made no reference to any statute, regulation, or court case which would require the Department to treat it as a start-up company for Indiana purposes while Taxpayer was treated under standard rules for federal purposes. Taxpayer has not met the burden of proving the proposed assessments wrong, as required by IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is denied.

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